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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1965.

No. 1253.

WILLIAM S. AND MARY P. SERRI,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

PETITIONERS' BRIEF IN REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION.

I.

CONFLICT BETWEEN THE CIRCUITS AS TO THE SIGNIFICANCE OF DISREGARDING UNCONTRADICTED TESTIMONY.

On April 22, 1966, the very day that the Petition for a Writ of Certiorari was mailed to Commissioner's counsel, the Court of Appeals for the Sixth Circuit reversed a deci-

sion by the same Judge Hoyt of the Tax Court who decided the instant case. In that case, *Stivers, et al. v. Commissioner,* — F. 2d — (CA 6, 1966); 17 AFTR 2d 865; 66-1 USTC ¶ 9379, Judge Hoyt refused to permit a rehearing to allow the introduction of evidence (cancelled checks) to substantiate the testimony of a witness (taxpayers' bookkeeper) which had not been challenged during the trial. The Court there said:

> "The Commissioner argues that these checks were filed too late and that the Tax Court was correct in refusing to consider them as evidence. The taxpayers contend that the above-quoted testimony of their accountant shows that actual payments were made to these route men and that these payments were deposited by the route men with the College; that no objection was made to this evidence nor was any proof offered to contradict it; that if there had been any indication of a question being raised on this issue, the checks would have been introduced at that time so as to establish these facts conclusively; and that the Tax Court therefore should have received the checks in evidence and should have reconsidered its decision in the light of the facts established by them.
>
> "The record indicates that these checks were available in the courtroom at the time the proof was taken. We think that the taxpayers were justified in concluding that introduction of the checks was not necessary in the absence of some factual challenge by the Commissioner. Not until the announcement of the decision of the Tax Court could the taxpayers have been aware that the Court would base its findings upon the statements of the bookkeeper on cross-examination to the effect that he did not have actual knowledge that the College received the checks from the route men.

* * *

"We vacate the decision of the Tax Court and remand the case for the taking of additional evidence on this point. 28 U. S. C. § 2106; 5 Am. Jur. 2d *Appeal & Error* § 972 (1962).

"On remand, the Tax Court is directed to admit the foregoing checks into evidence and consider them in determining whether or not W. E. Stivers actually sustained the claimed losses during the years for which they are asserted. Additionally, the Tax Court is directed to receive and consider any competent evidence offered by the taxpayers as to the payments made for stale bread losses by H. L. Stivers during the taxable years in question." *Stivers, et al. v. Commissioner,* — F. 2d — (CA 6, 1966); 17 AFTR 2d 865, 869, 870; 66-1 USTC ¶ 9379, pp. 85,869, 85,870.

This is precisely the same unfortunate plight in which the instant taxpayers were placed by Judge Hoyt. As the Petition for a Writ of Certiorari notes (pp. 18-26), Judge Hoyt peremptorily disregarded the unchallenged—and admittedly truthful—testimony of Commissioner's witnesses that taxpayer treated four patients an hour. Acceptance of this testimony would have clearly resulted in judgment for the taxpayers (Pet. 16-20). Taxpayers could have (1) produced actually hundreds of witnesses to confirm what had already been stated by Commissioner's own witnesses and (2) introduced the appointment books from the Camden office which showed that four patients were scheduled per hour, if taxpayers had had any inkling at all that Judge Hoyt had not accepted, let alone disregarded, the testimony of Commissioner's witnesses and would base his decision on the assumption of a "fact" that was not established by any evidence offered at the trial. Judge Hoyt, instead of questioning the testimony of the Commissioner's witnesses, actually indicated to taxpayers that he understood and accepted that testimony (Pet. 24-25).

Judge Hoyt's capricious denial, of a rehearing which would have afforded taxpayers an opportunity to introduce additional evidence to correct the error in the Tax Court's findings of fact, should have prompted the Court of Appeals for the Third Circuit to reverse the Tax Court's decision as was done by the Court of Appeals for the Sixth Circuit. This glaring disparity of treatment of taxpayers results in a clear conflict between the circuits which can only be effectively resolved by the remedial action of this Court.

It is respectfully submitted that the decision of the Court of Appeals for the Third Circuit violates the rules established by this Court for the protection of taxpayers when the Commissioner attempts to prove the fraudulent underpayment of income taxes by inferences to be drawn from the net worth method. As the Petition for a Writ of Certiorari points out (pp. 10-15), there are significant differences between the application of these principles by the Court of Appeals for the Third Circuit and the Court of Appeals for the First, Fifth and Sixth Circuits. These differences have led to an inequality of justice and the unequal treatment of taxpayers, depending solely upon which Circuit taxpayers happen to reside. Only this Court can correct this grave injustice. We submit that this issue transcends the instant taxpayers' tax liability, since uniformity and equality in the treatment of federal tax cases is essential.

II.

COMMISSIONER'S RELIANCE ON ERRONEOUS FINDINGS OF FACT BY THE TAX COURT.

Within thirty days after Judge Hoyt handed down his decision in this case, taxpayers filed a Motion to Correct Errors in Findings of Fact which cited eleven misstatements of fact relied upon by the Tax Court in its opinion. At the same time a Motion for Supplemental Findings of Fact was filed which requested a finding of twenty-two

essential facts that were favorable to the taxpayers and were undisputed. Sixteen of these requested findings were based upon testimony of the Commissioner's witnesses—including the Special Agent and the Revenue Agent—with the remaining six being based upon undisputed testimony of taxpayer and his witnesses. Both of these motions were summarily denied.

Many of the misstated facts are now cited by the Commissioner as support for his Memorandum in Opposition. In addition, the Commissioner draws inferences which are not proper when viewed in light of these undisputed facts which the Tax Court refused to find.

1(a) Statement—taxpayer opened his office between 7 and 8 A. M. and saw patients until approximately 12:30 at night (Memo. 2).

(b) Correction—This statement is misleading since the hours used represent Swedesboro starting hours and Camden closing hours, without noting that the Swedesboro hours ended around noon, while the Camden hours did not begin until 6:30 in the evening (R 84a-85a).

At the conclusion of the office hours the door was locked and taxpayer finished treating those patients who were present in the waiting room (R 83a, 97a-99a, 111a). The treatment of the remaining patients extended taxpayer's medical treating activity beyond the posted office hours (R 84a).

The significance is that it was stipulated that taxpayer worked 275 days a year (R 126a, 45b) and that the Tax Court found that his medical activities consumed fourteen hours a day (R 126a) of which thirteen hours were spent treating patients (Pet. 19-20). This is what is important and not that the holiday that taxpayer worked was Washington's Birthday, February 22, 1951 (R 119b).

The 275 days at thirteen hours a day are the figures which have to be used with the number of patients per hour and the stipulated fees to establish if taxpayer's medical practice could generate $240,000 of unreported income.

2(a) Statement—Taxpayers' records were totally inadequate and he did not identify a specific fee with a specific patent (Memo. 2-3).

(b) Correction—The Commissioner never asserted that the records were inadequate *per se,* but instead asserted that the records were inadequate because taxpayer spent more money than the records showed he earned (R 26a). This is dramatically illustrated by the fact that taxpayers' 1957 tax return was audited, in the middle of the fraud investigation, by the same Revenue Agent who prepared this case (R 25a, 51a-53a). That agent relied on the very same type of records to do the 1957 audit that he examined and rejected for the earlier years (R 52a). The agent admitted that the records were of the same quality as those of the earlier years and that there had been no change in bookkeeping procedures (R 52a-53a). The agent found that the records fully supported the 1957 tax return and it was accepted as filed (R 52a-53a). This clearly shows that the books and records were adequate. The Commissioner, in rejecting the earlier books and records because of the purchase of the antiques and art objects, is engaged in a boot-strap operation since he is assuming the very thing at issue—*whose money was used to acquire these items.* As the Commissioner points out (Memo. 1, 3), the alleged understated income is $240,000, and the expenditures for antiques and art objects was $240,000.

With a stipulated set fee it was not necessary to note the fee on the patient's record card. The fact that the visit was recorded was sufficient to calculate receipts. Presumably this is what the Revenue Agent did in determining that the 1957 return should be accepted as filed.

The Commissioner refers to the Tax Court's finding that many patient cards were lost. This is not correct. There was never any proof that any of the patient cards were lost. It was admitted that some 75 cards were discovered after the initial study of 5,000 cards was made

(R 117a-118a) and it was admitted that no one could swear that the revised study included all the cards and that none were omitted (R 138b-139b), but the Commissioner never produced a single witness who was not included in the study. Therefore, neither taxpayer nor the Commissioner knew of any patient who was not included in the study. The finding that many patient cards were lost has no basis in the record.

During the five-year period of 1952 to 1956 the Commissioner pointed out to the Tax Court that taxpayer made thirteen changes (all minor ones and generally only $10 or so) in the totals of his daily income (R 150b-162b). The Tax Court was critical of these "numerous changes" in income (R 126a), but had no comment on the remaining 1,492 days for which the Commissioner did not show any corrections of income.

3(a) Statement—Taxpayer did not contend until a year after the Service began its investigation that the funds used to buy the antiques and art objects were family funds (Memo. 4).

(b) Correction—Many years prior to the investigation taxpayer told disinterested third parties that the funds he was spending were Salvatore Serri family funds and not his own.

Leroy Ireland, a distinguished art expert, who advised taxpayer on his purchase of paintings, testified that in 1949, when he met taxpayer, taxpayer stated that he had $125,000 of the Salvatore Serri family money that he wished to invest in art objects (R 60a-62a).

Mrs. Leroy Ireland testified that she also heard taxpayer explain to her husband in 1949 that the money he was investing had been accumulated by the Salvatore Serri family over the years (R 64a).

John S. Walton, a noted New York antique dealer, testified that he met taxpayer in 1950, and taxpayer informed him that he had between $100,000 and $125,000 of money

that belonged to the Salvatore Serri family which he wanted to invest in antique furniture (R 90a, 93a, 96a).

4(a) Statement—Taxpayers' reported net income was insufficient to pay his stipulated living expenses (Memo. 3).

(b) Correction—A comparison between stipulated living expenses and net or taxable income is not realistic. The comparison should be between stipulated living expenses and spendable income. It is elementary that taxable income is determined by reducing net income by the amount of the personal exemptions claimed on the tax return. There is, of course, no dollar expenditure represented by the personal exemption deduction and, therefore, the personal exemptions should be added back to the taxable income figure as a preliminary step in determining spendable income. This adjustment affects the years 1954 through 1956.

After adding the exemptions to taxable income you have net income. To net income you add the optional standard deduction which, of course, does not affect spendable income. This must be done for the years 1947 and 1949 through 1955. This calculation results in a figure known as adjusted gross income.

To adjusted gross income there must be added the nontaxable portion of capital gains which were incurred during the period and the amount of depreciation (since such a deduction requires no outlay of cash) claimed on the tax return. At this juncture we have at last determined taxpayers' spendable income. The chart on the following page summarizes these additions and corrections.

An analysis of that chart reveals that the *spendable income available to taxpayers during the period exceeded their stipulated ordinary living expenses by $45,733.59.* Hence, Commissioner's comparison of "reported income" to stipulated living expenses is meaningless.

CALCULATION OF SPENDABLE INCOME

1	2	3	4	5	6	7	8
Year	*Net or Taxable Income Per Return*	*Exemption*	*Optional Standard Deduction*	*Long Term Capital Gain Exclusion*	*Depreciation*	*Spendable Income*	*Stipulated Living Expense*
1947	$ 15,399.28		$ 500	$ 562.50	$ 4,002.04	$ 20,463.82	$ 12,678.49
1949	20,695.21		1,000		4,566.79	26,262.00	15,688.46
1950	16,040.74		1,000		5,056.10	22,096.84	19,371.22
1951	14,812.70		1,000	735.23	4,655.92	21,203.85	19,769.33
1952	24,384.71		1,000		4,513.66	29,898.37	18,881.50
1953	22,889.71		1,000		2,188.10	26,077.81	24,109.85
1954	21,708.21	$ 3,600	1,000		2,888.77	29,196.98	27,821.37
1955	25,240.75	3,600	1,000		2,387.43	32,228.18	27,276.06
1956	23,745.84	3,600		545.17	4,031.50	31,922.51	28,020.49
	$184,917.15	$10,800	$7,500	$1,842.90	$34,290.31	$239,350.36	$193,616.77

Col. 2. R 167a, 181a, 187a, 195a, 202a, 209a, 216a, 219a, 227a.

Col. 3. R 216a, 219a, 227a.

Col. 4. R 167a, 181a, 187a, 195a, 202a, 209a, 216a, 219a

Col. 5. R 169a, 194a, 230a.

Col. 6. R 166a, 178a, 184a, 190a, 198a, 205a, 212a, 222a, 228a.

Col. 7. Sum of Columns 2 to 6.

Col. 8. R 132a-133a.

5(a) Statement—Salvatore Serri's estate was less than $5,000 (Memo. 4).

(b) Correction—The Commissioner cites the Tax Court's findings of fact (R 137a) as support for this statement. The Tax Court's opinion (R 155a) specifically states that the exhibit does not establish the truth of the matter contained therein. This is sound law. *Buhl v. Kavanagh,* 118 F. 2d 315 (CA 6, 1941).

Actually, the Commissioner's own witness, Maria Serri, taxpayer's mother, testified that the inheritance tax return was not complete since she did not count the cash in the safe to determine how much belonged to Salvatore Serri upon his death in 1944, because the money represented contributions by all the members of the Salvatore Serri family (R 118a-119a). Thus, the inheritance tax return was actually silent as to cash on hand.

6(a) Statement—Taxpayer did not give a convincing explanation as to why he borrowed money in 1954 to buy paintings at the Wilstach sale (Memo. 4).

(b) Correction—Taxpayer determined that it would be wiser to borrow rather than withdraw funds from the family accumulation because at that time John Walton was owed $21,680 (R 133a) and, in addition, Mr. Walton (R 67b-68b) was negotiating the purchase of additional antiques for the collection which apparently came to $8,550 since this was the amount spent with him in 1955 (R 131a). Thus, there was some $30,230 committed to Mr. Walton. By late 1954 the amount of uninvested cash in the family accumulation was greatly reduced and at best estimate would approximate something less than $49,000, which is the amount of the alleged unreported income for 1955 and 1956, as adjusted by the Kanady purchase (R 143a). Since over sixty per cent of this fund was committed to Mr. Walton, taxpayer decided to borrow $17,500 for the Wilstach sale

rather than take that much from the approximately $18,770 of uncommitted funds. Some of these uncommitted funds were, of course, later used to reduce the loan.

The fact that taxpayer borrowed money for the reasons explained above is not at all inconsistent with the fact that there was in existence during this period a family cash accumulation in excess of $240,000. See *Vernon H. Jorgesen,* 15 TCM 564 (1956), *Westerhaus Co.,* 16 TCM 958, 971 (1957), and *Fairchild v. United States,* 240 F. 2d 944, 947-948 (CA 5, 1957).

III.

COMMISSIONER'S AVOIDANCE OF THE BASIC ISSUES SET FORTH IN THE PETITION FOR CERTIORARI.

The Commissioner has used the expediency of ignoring taxpayers' position on the real issues of this case; in point of fact, he has studiously avoided them.

The Commissioner's memorandum does not concern itself with the degree of burden of proof the Commissioner had in order to negate the family funds. It simply states (Memo. 5-6) that it was negated and thus if there were no family funds then taxpayer consistently spent more than he reported as income and the petition should be denied.

Similarly the Commissioner does not address himself to the requirement that he has the burden of making proper allowance for cash on hand, especially in light of the fact that the Tax Court found that some funds were turned over to taxpayer following his father's death in 1944 (Pet. 12-15).

Taxpayers pray that this Court will carefully review the significant issues that are present in the case and grant the petition in order (1) to give fundamental justice to the taxpayers and (2) to protect all other taxpayers from the downgrading of the burden of proof that the Court of Ap-

peals for the Third Circuit has now sustained, and (3) to resolve the conflicts between the Third Circuit and those of the First, Fifth and Sixth Circuits in order that the law pertaining to net worth cases will be uniformly interpreted.

Respectfully submitted,

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